
Public Financial Crisis

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It is no longer easy to write a book on the global financial crisis, even though its aftershocks continue to linger. This is because a lot has already been, and continues to be, written on a subject explored, dissected and microscopically from every conceivable angle. The question that inexorably arises while reviewing a book of this sort is what is distinctive that would keep the reader interested? I can think of five reasons.

Distinctive Reasons

First and foremost, with the worst of the global financial crisis now behind us, the book focuses on the aspect that demands more attention, namely, the growing crisis in public finance. It is becoming clear that policymakers engineered an exit from the global financial crisis not by reducing leverage that lay at its roots, but by converting private debt into public debt. The global financial crisis is now morphing into a public financial crisis from which exit may be as painful as from the global financial crisis.

Second, this is a book by two erstwhile policymakers, including a former central banker and author of a path-breaking report on federal-state fiscal relations in India, and a professional economist. It is therefore a heady mix of practical policy concerns with academic insights thrown in.

Third, it is an analysis of what was essentially a Western economic crisis by experts with direct policy experience in managing a major emerging market through major crises. These concerns are reflected in the questions they raise, and the manner in which they seek to answer them. In the end, however, the reader might come away with the impression that after competently presenting both sides of the argument, the two-handed economist has prevailed over the practitioners because the authors by and large eschew positions on major

BOOK REVIEWS

Financial and Fiscal Policies: Crises and New Realities by Y V Reddy, Narayan Valluri and Partha Ray; *New Delhi: Oxford University Press, 2014; pp xviii and 344, Rs 995.*

policy debates, such as the one pitching “growth versus austerity,” and the pros and cons of using monetary or fiscal policy, including their efficacy.

Fourth, the best sections of the book are undoubtedly their analysis of the continuing crisis in the eurozone—where, like Tolstoy’s unhappy families, the crisis in each country had different roots, such as fiscal overstretch (Greece), real estate bubble (Spain), private debt (Ireland)—and the theoretical discussions at the end distilling cross-country experiences.

Similarity with Developing Countries

This is unsurprising because there are aspects of the eurozone crisis that mimic those in developing countries. In a number of eurozone countries fiscal weakness and overconsumption leading to widening current account deficits were the major causes of crises that manifested themselves through market revolt that impaired their ability to continue financing the deficits. This is a pattern familiar in developing countries. The United States (us) and the United Kingdom (uk), on the other hand, with their deep reserve-currency pockets, never had problems in financing external or domestic deficits. Fiscal weakness in these countries, as in Japan earlier, was essentially the consequence of the financial crisis, deriving from the need to bail out a failing financial sector and to stimulate their economies back to growth. The “exorbitant privilege” and inequity inherent in the international monetary system is touched upon by the authors, but like all others they run into

the “TINO” reality. The reserve currency status, after all, is bestowed by financial markets and not by institutions such as the International Monetary Fund, G-20, Bank of International Settlements or the United Nations.

Fifth, theoretical issues are explored through the prism of the global financial crisis as it developed in the us and the uk; its spread to the eurozone, and finally its impact on India. The latter chapter, while substantive and containing deep insights, is, however, not very well integrated with the rest of the book. The reason for its inclusion is not very clear other than for the obvious fact that the authors are familiar with the terrain. Its overall tenor is rooted in domestic debates over growth, prudent deficit levels and use of macroeconomic tools which non-Indian experts might struggle to follow. Ideally this section should have been on emerging markets, with India as an illustrative case. With its structural current account deficit, outsized fiscal deficits, and greater reliance on domestic demand, India can hardly be considered a good proxy for emerging markets as China, East Asia and Latin America are all very different.

What emerges clearly is that discretionary fiscal policy during the crisis was used more in developing countries of the G-20, whereas developed countries relied more on automatic stabilisers. Also, since much of this involved state-directed infrastructural investment it was more effective in getting growth back on track, at least over the short term. The deleterious long-term effects are however beginning to be felt now in terms of lower growth and over-extended fiscal or, as in the case of China, financial balance sheets. China ought to have spent more on consumption, but did more on investment; likewise, the us should have spent more on investment, but spent more on consumption. Both countries therefore tended to amplify their imbalances, even though global imbalances as a whole declined because of lower aggregate growth.

China is now restructuring its economy; the question is whether the us is

also doing so. It can finance large current account imbalances, but with growing inequality, stagnant real wages, fall in labour participation rates, and household deleveraging it may be forced to adjust towards lower consumption against the backdrop of tighter financial regulation where reckless lending of the NINJA (no income no job or asset) variety may no longer be possible. This would, however, come at the cost of lower growth unless it is able to substantially increase investment. Unless, of course, we were to move permanently from Bretton Woods II, characterised by unsustainable private debt that culminated in the last financial crisis, to Bretton Woods III, characterised by unsustainable public debt leading inexorably to the next financial crisis.

The authors have little new to say about the origins of the global financial crisis that lay in the sub-prime housing market in the US and UK dominated by opaque shadow banking, accumulation and accentuation of global imbalances, the growing deregulation of Western financial markets, loose monetary policies and rising income inequalities. This is understandable because the focus of the book is on financial crises and fiscal policies, as the title makes amply clear. It is on the strength of this important matrix that the book stands.

Nuanced Analysis

The nuanced analysis of the relationship between the financial sector and the fisc is undoubtedly the high point of the volume. After reading the book it is clear that the fiscal capacity of a country to sustain market pressures depends on whether it is a reserve currency issuing area, and even if it is, whether it is part of a currency union, and if it is, whether the currency union is optimal. If it is suboptimal, as is the case with the eurozone, countries with high fiscal and current account deficits and private debt need to watch out. For non-reserve currency areas, the denomination of sovereign debt is crucial, with a higher external component (“original sin”) making it more vulnerable than others.

Since the book is about the link between the fisc and financial markets,

differential fiscal capacities are mostly discussed in relation to market revolt. The study does not delve deep into the issue of what level of domestic currency sovereign debt is sustainable. The question of market revolt does not arise in such cases, as such debt is backstopped by the central bank. The concerns rather are domestic macroeconomic instability (such as high inflation) resulting in lower growth.

The issue is briefly raised through the Reinhart and Rogoff (R&R) and Cecchetti, Mohanty and Zampolli debt/GDP benchmarks, but explored only in the Indian case study, underscoring the reader’s disappointment with integration of the Indian case with the wider theoretical framework and analysis. The discussion of India’s fiscal targets are within the parameters of the country’s internal debate centred on its statutory Fiscal Responsibility and Budget Management (FRBM) targets, which in turn appear to be a rigid application of the European Union (EU) Maastricht Treaty norm of 3% rather than of any Domar type debt sustainability calculations that link debt sustainability to a country’s potential growth.

Anomalous Understanding

It seems anomalous that after a scathing criticism of its fiscal management the authors blandly acknowledge that India’s debt/GDP ratio, far below the R&R benchmark to begin with, actually declined despite the crisis-related stimulus. The table on page 84 indicates that India’s discretionary fiscal stimulus was the smallest amongst G-20 countries. The authors also acknowledge that India has avoided the original sin of a large external debt. Their conclusion at p 226 that “without being alarmist, if and when any serious deterioration happens in global economies, given the ever-increasing trends in India’s globalisation, (without continuing fiscal correction) India could be exposed to the crisis and contagion” is consequently not persuasive. India’s main vulnerability flows from its current account, rather than its fiscal deficit, as both its domestic and external debt are far below the R&R and Cecchetti et al

thresholds. India arguably needs to use the fiscal space created by rising growth rates more aggressively for quickly plugging its infrastructure deficit to sustain its high growth potential, rather than relying heavily on private investment as it has tended to do thus far. It is the quality, rather than quantity, of the fiscal deficit that is the main source of concern.

Since the volume discusses the crises in both the US and the eurozone as part of its cross-country experience, the authors could perhaps have thrown into sharper relief critical differences between the two financial crises. In the US and UK, the crisis was more about opaque shadow banking instruments, the failure of lightly regulated investment banks, and about financial institutions too big to be allowed to fail (TBTFF) for systemic reasons.

In Europe, on the other hand, where shadow banking played a much more modest role, the crisis centred more on traditional deposit-based banking and, because individual bank balance sheets were much larger relative to their governments, on “Sovereigns Too Small To Bail Out” (TSTBO) but Too Big to Fail (TBTFF) financial institutions. This is why several countries needed external assistance from stronger members of the EU, the IMF and the European Commercial Bank (ECB) as their own central banks were not in a position to backstop liabilities denominated in their domestic currency. Crises-affected countries within the EU that were in a position to backstop and devalue their currencies, such as Iceland, recovered much faster, as the authors themselves point out (p 142). Ironically, it now appears that tighter regulation of traditional banking might push it increasingly into the shadows, where the global financial crisis originated, making the European financial system increasingly resemble that in the US.

Suboptimality

The continuing crisis in the eurozone is indicative of the “suboptimality” of the European Monetary Union, rushed through as a political project, which is dealt with great clarity by the authors.

The authors are in agreement with this writer that the IMF bailout of eurozone countries was not warranted under its Articles of Agreement and because the big bazooka that effectively bailed them out—the ECB—lay within the eurozone all along. The analysis makes it clear that the lingering crisis in the eurozone is unlikely to go away without deeper financial (banking) and fiscal integration as markets have discovered the suboptimality of the European Monetary Union and can therefore be expected to revolt from time to time, given the public sentiment against “transfer union” amongst the stronger member of the eurozone.

The final section of the book is devoted to what the authors have rightly identified as emerging questions and challenges. The biggest challenge is the ballooning public debt in developed countries to levels unprecedented in peace time, raising the kind of concerns that were heretofore reserved for developing countries where such high levels of debt have been a major source of both domestic and external crises, including financial crises.

This challenge is perhaps grimmer than the fiscal dominance underscored by the authors. The US Congressional Budget Office’s latest projections do not show the US public debt stabilising over the long run on account of escalating social security deficits. The US was able to grow out of its post-war debt through a combination of financial repression and economic growth, facilitated by post-war reconstruction and baby boomers. The US today is, however, demand-constrained and though it remains an immigrant society it is appreciably older. Its lower “new normal” growth potential might constrain it to rely much more on financial repression to mark down its debt. The position in Europe and Japan is far worse.

In fact, the toxic combination of declining growth and ageing was straining welfare-oriented fiscal management in advanced economies across the board even before the global financial crisis. The difficulties in conforming to the Maastricht Treaty fiscal targets were symptomatic of this. The fiscal demands

of managing the financial crisis have only anticipated rather than caused the fiscal crisis.

Challenges before Advanced Companies

Can advanced economies generate the growth, and through it higher taxes, to pay down such high levels of public debt? Deficits and debt are after all deferred taxes. Tax policies constitute the second emerging issue and challenge that extends far beyond the issue of taxing the financial sector on the “polluter pays principle” underscored by the authors.

Simply raising taxes in what are already high taxed and globally uncompetitive economies would further strangle growth and exacerbate external imbalances. It is, therefore, difficult to see how the fiscal imbroglio can be managed without resort to politically difficult structural reforms that the G-20 has been trying to push through its Framework for Strong, Sustainable and Balanced Growth. The highly successful German reforms under Chancellor Schroeder that turned around deficits are a pointer to what is possible by bridging the “Growth–Austerity” divide: austerity was put on hold to manage the political fallout of difficult reforms. This is also an abject lesson for emerging markets that are in the process of putting in place their own social contracts: Fast growing young societies can afford generous social security schemes; but these become unsustainable as growth slows and societies age.

The large external demand for reserve currencies on account of global imbalances, spare capacity and weak private demand has, so far at least, prevented high levels of deficit and debt from creating the kind of crowding out effect and macroeconomic instability they generate in developing countries. Extraordinarily easy monetary policies in these countries, including quantitative easing that have seen central banks purchase large amounts of government paper, have also helped in keeping interest rates on government debt low. But what of the future? Global imbalances could abate; already China has

embarked on a conscious policy of rebalancing its economy towards domestic demand. Interest rates could also rise.

This leads logically to the third set of emerging questions that revolve around the role and future course of monetary policy that extend far beyond fiscal dominance, financial repression and the newly rediscovered second objective of financial stability underscored by the authors. Although most developed countries have started exiting from stimulative fiscal policies, extraordinary monetary policies at the moment seem akin to trying to escape the gravitational force of a black hole.

The mechanics of exit seem so complex that the US Fed is baulking at normalising monetary policy despite clear signs that the US economy is recovering. A significant rise in interest rates could not only further strengthen an already strong dollar and prick the recovery, but the Federal Reserve would take a big hit on its bloated balance sheet were it to roll it back. The interest burden on refinancing of government debt would also go up. Both of these would worsen the fiscal and debt position. When, indeed whether, monetary policy would return to the cozy world of the Taylor Rule remains moot. Indeed there is debate over raising the inflation target in the monetary rule, which in a sense would be inflating away public debt in an orderly manner.

Eurozone Debt Restructuring

The fourth and final set of emerging questions centre on debt restructuring and default. This is largely seen in the context of eurozone countries where domestic debt has the characteristics of external debt as they cannot inflate it away. Debt default is disastrous over the short term as this results in loss of market access. It is because of this reputational damage that the authors do not recommend going down this path. However they also quote from a McKinsey study that found medium- to long-term gains from rapid deleveraging in terms of growth and macroeconomic stability. Markets however have a short memory, and defaulters have been known to

regain access once fundamentals have improved.

What applies to public debt applies equally forcefully to private debt that deters people from spending the policy stimulus to expand demand and economic growth, using it instead to accelerate debt repayment. This is, in a sense, the working out of Ricardian equivalence

for which the authors do not find definitive evidence.

It is not possible to explore the complexities of the recent global financial crisis within the confines of a single work. The authors have done a commendable job of exploring the linkages between fiscal policies and financial crises in an intellectually stimulating

manner, bringing to bear their formidable policy experience. There is something for policymakers, analysts, students and academics to take away from the book, and they would all benefit by reading it.

The views expressed here are personal.

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